# Target retirement

## A graduated asset allocation strategy starts out aggressive and becomes conservative over time, but is this good for your client, asks JIM OTAR

After the last market crash, many financial advisers moved from pure equity to balanced funds. One of the benefits of holding balanced funds is that I can literally fall asleep at the switch for a few years and portfolios will not get hurt beyond the normal fluctuations.

Some fund companies are moving a step beyond the balanced funds. The target retirement funds start aggressively and become more conservative over time. This strategy is generally known as 'graduated asset allocation'. If I buy these funds for my younger clients, I can then fall asleep at the switch, not only for a few years but a few decades. Can this be true?

There are two main categories of asset allocation (AA) strategies: market-based and client-based.

Market-based strategies react to prevailing market trends. Trend Following, Tactical, Dynamic and Flexible AA are some of the popular strategies in this category. We will look at market-based strategies in future articles.

On the other hand, client-based asset allocation strategies ignore the market trends and focus on the investor. The following three are the popular ones:

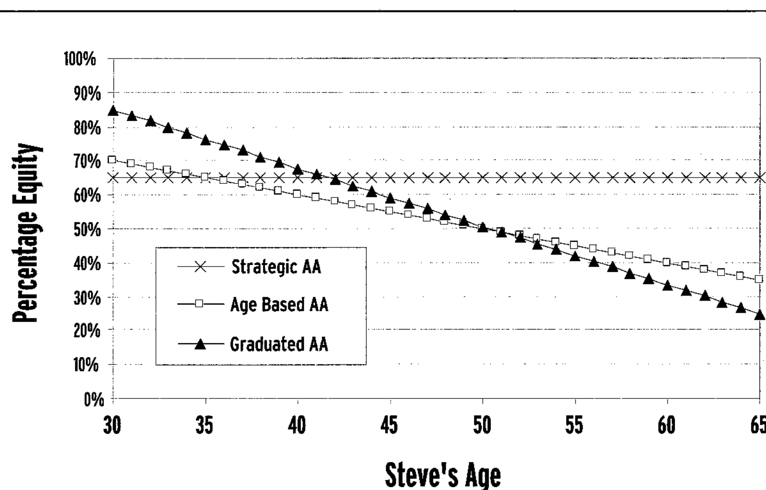
→ **Strategic AA** – decide on an asset mix based on the client's risk tolerance and stick with it over time.

→ **Age Based AA** – the equity percentage in the portfolio reduces by age. Typically, the equity percentage is equal to 100 minus age. If you start saving at age 30, you would have 70 per cent equity and 30 per cent fixed income. Thirty-five years later, by age 65, you would have 35 per cent equity and 65 per cent fixed income.

→ **Graduated AA** – they are a more extreme version of the Age Based AA. For example, if you are 35 years away from your retirement, they would typically start with 85 per cent in equities and would come down to 25 per cent by age 65.

To analyse the effect of each of these three strategies, let's look at an example: Steve is 30 years of age. He is just starting to save for retirement. His retirement account currently holds only $10,000. He plans to save $10,000 annually, indexed by 3 per cent until age 65. He wants you to choose between the Strategic AA (65/35

## CHART 1



Equity/Bond), Age Based AA and the Graduated AA. He asks: "Which one of these three strategies will give me the highest dollar amount at age 65?"

Chart 1 shows the percentage of equity in Steve's portfolio for each strategy over his 35-year accumulation time horizon. For calculation purposes, I assumed a steady, annual decline of the equity percentage for the Graduated AA. In real life, asset mix changes are done less often, perhaps once every five years.

I plug these numbers into my retirement calculator that is based on market history. When I look at all portfolios since 1900, the median portfolio value (median is where half of the outcomes have higher and half have lower portfolio assets) presents a very interesting picture as seen in Chart 2.

For the median portfolio, it makes almost no difference which one of these AA strategies Steve follows. At age 65, the dollar difference between any two strategies is less than 2.1 per cent. Here is a shocking revelation: all other things being equal, missing only one year's contribution will have a significantly worse effect on the outcome than choosing the 'wrong' AA strategy. So, the best advice that I can give Steve is: "It doesn't matter which one of these three strategies you follow, just

**Continued on page 24 →**

## Save religiously, follow the strategic asset allocation strategy, and review the asset mix/performance regularly.

**Continued from page 23 →**

make sure that you save regularly!"

What if Steve gets lucky and catches a secular bull market? Here, lucky means the top decile of all outcomes since 1900. The next chart has the answer. At age 65, the Strategic AA made 23 per cent more money than the Graduated AA. This is a significant difference. This came at a slightly higher volatility. But I don't care about the volatility when looking at lucky outcomes. This is the 'good' volatility and I don't consider it a risk factor. (See Chart 3.)

What if Steve is unlucky? Here, unlucky means the bottom decile of all outcomes since 1900. At age 65, the Strategic AA produced 7 per cent more money than the Graduated AA. You might say: "But this must surely come at a higher risk!" No, that is not true. The standard deviation of annual returns for the Strategic AA was 1.7 per cent and for the Graduated AA, 2.2 per cent. Yes, you can have your cake and eat it too. (See Chart 4.)

My conclusion for accumulation portfolios is: Save religiously, follow the strategic asset allocation strategy, and review the asset mix/performance regularly. The graduated asset allocation strategy is not for my clients. As for me, the adviser, I promise I won't fall asleep at the switch! ✤

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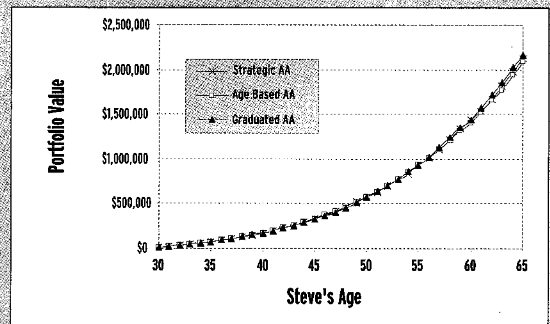
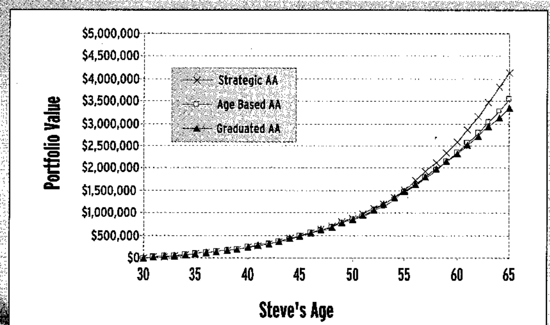
## CHART 2




## CHART 3




## CHART 4